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Review

Pensions

Income drawdown – opportunity knocks

Amongst the new legislation issued over the last few months observant trustees and employers will be aware that one pre-Election pledge, to remove the requirement to annuitise DC funds by age 75, has found its way into the Finance Bill[1], together with new income drawdown rules. Those with DC plans may have added this to the pile marked “high earner issue – revisit at a later date”. Those with DB plans may have signed off this issue as simply “not applicable”. As highlighted below, we believe that both of these views are misconceptions.

Pension plans do not have to offer the new flexibilities for income drawdown discussed in this communication. However, in line with their fiduciary duties, trustees should not overlook the merits (and complexities) of introducing certain radical benefit changes which will be of interest to some members. Employers may also face pressure from employees wishing to take advantage of the new drawdown rules; some may even see scope to use the new rules as a method of derisking for DB plans.

The Finance Bill removes the current requirement for pensions income to be secured by the age of 75.

Impact on Defined Contribution plans

When a member wishes to retire from a DC plan, the almost universal practice is to purchase an annuity from an insurance company to secure his income throughout retirement. DC plans have for some years been able to offer members the option of drawing down a limited amount of annual income without purchasing an annuity. However, the withdrawal amounts have been subject to limits and the administrative complexities have tended to deter trustees from offering this choice. Therefore, the minority of members wishing to defer annuity purchase have normally achieved this by transferring their benefits to a personal pension plan which allowed income drawdown.

The Finance Bill removes the current requirement for pensions income to be secured by the age of 75. A member may in theory be able, once the Finance Bill is enacted, to draw down income from age 55, without that constituting an unauthorised payment. The size of the amounts withdrawn will depend on whether the member has enough funds to meet a new test, the Minimum Income Requirement (MIR). The change to income drawdown rules therefore represents a revolutionary change to the way in which members can take their retirement income.

Flexible drawdown

If an individual’s annual pension income from all sources, including the state pension, meets the MIR of at least £20,000 then new rules may permit excess retirement savings to be drawn down as one or more lump sums, taxed at the member’s marginal income tax rate. There is no cap on the amount that can be withdrawn.[2] Such lump sums can be taken in addition to the existing tax free cash lump sum. Experience shows that lump sum options are popular with members. There are also clear advantages for members whose income tax band will be lower in retirement.

The pension payments that count towards the MIR are set out in draft legislation. These include pensions in payment from most[3] occupational and personal pension plans and from the state pension. The basic state pension is currently approximately £5,300 per annum. So a member who currently has an annual pension income of over £14,700 from occupational or personal pension plans could potentially benefit from flexible drawdown. This is not just a ‘high earner’ issue: it can benefit average earners who have been members of pension plans for a large part of their working lives. According to research[4] by the Pensions Policy Institute it is estimated that 12% - 16% of people in the UK aged between 55 and 75 might be able to meet the MIR in 2010 or by their State Pension Age.

Other drawdown options

Members who do not have sufficient pension savings to meet the MIR can still benefit from income withdrawal. This is called capped drawdown and will be subject to a cap of 100% of the equivalent annuity purchase.

1 Finance (No.3) Bill published on 31 March 2011.
2 The member’s overall level of benefits will be subject to testing against the Lifetime Allowance.
3 For example, pensions paid from pension plans with less than 20 pensioners may not count towards the £20,000 MIR.
4 Statistic taken from the Pensions Policy Institute report “*Retirement Income and assets: the implications of ending the effective requirement to annuitise by age 75*”

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DC considerations – trustees

In accordance with their fiduciary duties trustees should consider whether any plan design changes are in the best interests of the members. Any decisions should take into account the undeniable administrative complexities of making such changes and the increased risk of error from continuing to administer members' funds after the point when otherwise they would in the past have either bought an annuity or transferred out to a personal pension. This is not a 'now or never' decision – options can be reconsidered at some future point in response to member interest or when such flexibilities become a more commonplace offering.

This is not just a 'high earner' issue

DC considerations – employers

Employers may have a more immediate interest in offering flexibilities, especially for senior or long serving employees, many of whom are likely to have DC benefits following the recent wave of DB closures.

Impact on Defined Benefit plans

Although the income withdrawal opportunities highlighted above cannot be offered directly by a DB pension plan, they do open up possibilities for de-risking some DB liabilities, if a DB member is happy to use the MIR as a target secured income figure and wants greater flexibility over cash sums. This would require such a DB member to transfer some of his benefits to a DC arrangement. Many pension plans do not currently offer partial transfers of benefits but the plan rules could be amended. Members who have met the MIR as a result of savings through a variety of DB plans and other eligible sources may be interested in a transfer out of their full benefits from a given DB plan if those benefits are in excess of the MIR.[5]

Pensions payable from a standard DB plan are at least in part inflation linked and many have attaching spouses' pensions. The value of these benefits, when converted to a non-escalating single-life pension can produce a much higher pension amount, to be measured against the MIR. DB members who have entitlements to pension increases, or whose spouses are separately provided for, may be interested in such benefit transfers to enable them to meet the MIR although such transfers would need to be made on an informed consent basis.

DB considerations – employers and trustees

Many DB pension plans are undergoing benefit reviews, prompted by the reduction in the Annual Allowance to £50,000. This is a good time to consider opportunities to enhance flexibility for members and assess possible derisking options. Of course, member communications would need to be handled sensitively. Employers and trustees should bear in mind the fine line between 'explanation' and 'promotion' when communicating financial information to members – be careful not to stray over that line, especially where members are offered choices/incentives.

Action

For now, we suggest that employers and trustees familiarise themselves with the opportunities offered by the new legislation to enable discussions to take place regarding the desirability of making any changes. The Finance Bill has not yet received Royal Assent so employers and trustees do have time to assess their strategy. Some of the necessary subordinate legislation has been drafted, however, as has draft guidance by HMRC.

Legal advice should be sought to ensure that any proposed amendments are in line with the trust deed and rules and the legislation. We would be happy to help clients to assess the relative merits and risks of any proposal.

Further information

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5 The technical difficulties relating to transfers of benefits with associated Guaranteed Minimum Pensions, from a contracted-out plan, may need to be assessed.

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